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IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

No. 485

SAMUEL GALEWITZ and MARIAN GALEWITZ,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on June 2, 1969.

Opinions Below

The opinion of the Court of Appeals, as yet unreported, is printed in the Appendix, *infra*, pp. 1a-10a. The opinion of the Tax Court of the United States is reported at 50 T.C. 104, and is printed in the Appendix, *infra*, pp. 11a-25a.

Jurisdiction

The judgment of the Court of Appeals was entered on June 2, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1).

Questions Presented

1. Does the origin and character of the claim, with respect to which the petitioner incurred his legal expense, determine whether such expense is deductible, within the purview of Sec. 212(2) I.R.C.?

2. Was the legal expense incurred by the petitioner for the purpose of conserving or maintaining his income-producing property, within the purview of Sec. 212(2), I.R.C., when it was expended in defense of an action seeking income for the claimant, accusing him of impropriety, falsification and fraud in the issuance to him, and his ownership, of certain dividend-paying securities, and of defrauding complainant, by means of fraudulent and illusory transfers, of her widow's statutory rights to one-third income for life in these securities, and terminating in dismissal of her complaint after trial and appeal on the grounds that her action was wholly without merit, completely unfounded, and not bona fide?

3. Did the Court below err when it interpreted the word "defending," as employed in Sec. 1.212-1(k), Treasury Regulations, to mean that the legal expense incurred by the petitioner for the defense of an action, was a capital expenditure to be added to the cost of his property, regardless of the facts that the claimant sought only income for herself; the title to his income-producing property was only incidentally or potentially involved; the Tax Court made a judicial determination that the complainant's action was dismissed on the grounds that it was wholly without merit, completely unfounded, and not bona fide; and

the value of his property was neither added to nor enhanced, nor was his title perfected in any way?

4. Did the Court below err, as a matter of law, when it reversed the finding of the Tax Court that the legal expense incurred by the petitioner bore a reasonable and proximate relation to the conservation or maintenance of his income-producing property?

5. Did the Court below err when it reversed the decision of the Tax Court and no clear-cut mistake of law was established in the record?

Statutes and Regulations Involved

The pertinent provisions of Sec. 212 of the Internal Revenue Code, 1954 (26 U.S.C. Sec. 212) and of Sec. 1.212-1 of the Treasury Regulations (26 C.F.R. Sec. 1.212-1), are printed in the Appendix, *infra*, pp. 26a-27a.

Statement of the Case

(1)

Jacob Galewitz, the father of Samuel Galewitz (hereinafter called the "petitioner"), died testate. In his will, Jacob provided that Hannah (his widow and second wife, and step-mother of petitioner) was to receive $2,500, cash, and, in addition, the income for her life of one-third of his estate; and the principal was to be divided equally among his six children (all of his children of his first and second marriages).

The legal fees in issue in the instant case were paid by the petitioner for the successful defense of the following litigation instituted by Hannah in the Supreme Court of the State of New York, New York County: She claimed that the petitioner "improperly, falsely and fraudulently claimed and asserted" that he was the owner of certain

shares of stock; that the petitioner "improperly, falsely and fraudulently claimed that Jacob had arranged and undertaken to issue and/or transfer" such shares to him; that such alleged transfer "constituted a fraudulent and illusory transfer of the assets of the said Jacob, deceased, in fraud of the petitioner's rights under Section 18 of the New York State Decedent Estate Law, as the widow of the said decedent, Jacob." She demanded judgment that these shares be set aside and declared void and a fraud on her rights as the widow of the decedent; that the petitioner be stayed and enjoined from transferring said shares pending the final determination of said action; and that a Receiver thereof be appointed during the pendency of such action.

The petitioner denied the allegations of her complaint and demanded judgment dismissing her complaint.

After a trial on the merits, the Trial Judge found that Hannah's testimony "is utterly incredible"; that "there was nothing of an 'illusory nature' in the ownership" by the petitioner of these shares; that her claim that these shares belonged to the estate "is wholly without credible support in the record"; that there was no evidence of "wrongdoing of tangible, believable character" to support her contentions of petitioner's alleged "impropriety, falsification and fraud"; that the entire evidence presented "indisputable proof of the unassailability of the transaction under attack"; and granted judgment dismissing her complaint. (*Galewitz* v. *Walter Peek Paper Corporation,* 15 Misc. 2d 179, 182 N.Y. Supp. 2d 750, 1958; affirmed unanimously, 9 App. Div. 2d 621, 191 N.Y. Supp. 2d 359, 1959).

(2)

The Tax Court upheld the petitioner's view that his legal expense was a proper deduction within the purview of Sec. 212(2) of the Internal Revenue Code, as it was an

ordinary and necessary expense paid for the management, conservation, or maintenance of his shares of stock held for the production of income.

The Tax Court, in its opinion, *infra,* found the following:

a. The "primary objective of Hannah's suit was to augment and increase her share of the income of the estate, and to obtain an accounting of the profits or earnings" of petitioner's shares. The petitioner had received "regularly, substantial dividends" on these shares. As the net estate was about $716,000, there was "no problem here about the payment of the ($2,500) cash bequest to the widow." Her interest in the estate "was limited to a life interest in the income of one-third of (Jacob's) estate"; and if she were able to prove that the issuance of these shares was "illusory and fraudulent" and that these "had belonged, in reality, to Jacob, and hence to his estate upon his death, the amount of the income of the estate would have been increased substantially, and so would her share of that income."

b. "Upon all of the evidence here, we must find and conclude, and we do, that Hannah's claims and lawsuit were wholly without merit and were completely unfounded."

c. The "petitioner's purpose in incurring the legal fees in issue to resist Hannah's groundless efforts to obtain a transfer of his 5 shares of Peek stock to the executors of the estate of his father, Jacob, deceased, was not to perfect Samuel's title to the shares, but was to maintain and conserve his income-producing property, and was to fend off an attack which was not bona fide."

d. The facts in the instant case were "similar" to those presented in three cited cases: *Hochschild* v. *Commissioner,* 161 F. 2d 817 (CA 2, 1947); *Sergievsky* v. *McNamara,* 135 F. Supp. 233 (SD NY, 1955); and *Willy Zietz,* 34 T.C. 369 (1960) (Acquiesced in by Commissioner on this point

in 1960-2 Cum. Bull. 7). In each of these three cases, "the taxpayer paid legal fees for the successful defense of an action challenging his rightful ownership of dividend-paying securities, such challenging action having been judicially determined to be 'ill-founded,' or 'wholly without merit,' or an 'abortive attack.'" "The reasoning in each of the (three cited) cases, applies here."

e. "The legal expense bore a reasonable and proximate relation to the conservation of property (shares of stock) held for the production of income"; and "comes within the scope and meaning of section 212(2), 1954 Code, and is deductible." Such expense was not to be "capitalized as a capital asset" on the ground that it was "incurred to defend title to and ownership of (petitioner's) shares of stock," as contended by the Commissioner.

(3)

The Court of Appeals, in its opinion, *infra*, upheld the view of the Commissioner that the legal expense in issue was incurred to "defend" the "title" to petitioner's shares of stock and "hence constituted part of the cost of the property and not a deductible expense"; and reversed the decision of the Tax Court.

The Court of Appeals made its determination despite the above findings made by the Tax Court.

The Court rested its decision upon the bare words "defending * * * title" in the Regulation. It held:

> "Its language is plain and unqualified. It draws no distinction between defenses of title against attacks which are not bona fide and defenses against attacks which are. If the taxpayer incurred expenses in defending his title, the expenses are not deductible, regardless of the nature of the attack."

Further, the Court held it was of no "critical significance" that Hannah's purpose in suing the petitioner was to increase her "interest under the will," which was "the income for life from one-third of (Jacob's) estate."

Also, the Court found that the facts in the above three cases cited by the Tax Court were "distinguishable from the present case" and "sufficiently different to make the decision(s) inapposite here."

Finally, the Court declared:

> "Obviously, in every case a taxpayer who succeeds in retaining his property against an unjustified attack 'conserves' it in a certain sense. But 'conservation' must have a narrower meaning than this. The statute and the regulation exist side by side and it would make no sense to say that every case which falls within the regulation also comes within the statute. We recognize that cases may arise in which it may be difficult to draw the line between them. This does not appear to us to be such a case. If the regulation is to have any vitality, it must govern here."

Reasons for Granting the Writ

1. The decision below apparently conflicts with this Court's decision in *United States v. Gilmore*, 372 U. S. 39, that the origin and character of the claim should determine deductibility of attorney's fees as "income" versus "title."

This Court held in the *Gilmore* case that the test whether a legal expense was "business" or "personal", for the purpose of determining whether it was deductible under Sec. 23(a)(2), I.R.C. 1939 (now Sec. 212(2), I.R.C. 1954), was controlled by the "origin and character of the claim with respect to which an expense was incurred, rather

than its potential consequences upon the fortunes of the taxpayer." (372 U.S. at p. 49).

It is respectfully submitted, that the same "origin and character of the claim" test should logically and realistically apply as well to determine whether a legal expense was "income" within the purview of Sec. 212(2) of the Code or "title" within the purview of Sec. 1.212-1(k) of the Regulation.

In the instant case, the Tax Court found and the Court of Appeals conceded that the sole purpose of "Hannah's suit was to augment and increase her share of the income of the estate." The "origin and character of her claim" was to obtain "additional" income for life, to the extent of one-third of the past and future dividends earned from petitioner's shares. Accordingly, the Court of Appeals erred when it contended that such "origin and character" was of no "critical significance."

There have been numerous reported decisions (and, certainly, there will be many in the future) in which the "origin and character of the claim" was "income", while the potential consequences involved the taxpayer's "title" as an incident thereto, and the Courts either allowed the question to remain in suspense or rendered conflicting decisions as to the controlling test. (See the concurring opinion of Tax Court Judge Tannenwald in the case of *Herman A. Moore, Trust,* 49 T.C. 430, 443-44, 1968, for a detailed discussion on this point, and the conflicting tests adopted.)

This Court should resolve such conflict and uncertainty. It is in the interest of the Treasury Department, as well as the many taxpayers involved, to determine whether the objective test of "origin and character of the claim" should control whether an expenditure for legal fees or similar costs is deductible as "income" within the purview of Sec. 212(2) of the Code, or it is non-deductible as "title."

2. The decision below conflicts with this Court's decision in *Trust of Bingham v. Commissioner*, 325 U. S. 365, that the Tax Court is the trier of the facts of reasonableness and proximity.

This Court held in the *Bingham* case that "questions of reasonableness and proximity are for the trier of fact, here the Tax Court." (325 U.S. at p. 370)

In the instant case, the Tax Court held that petitioner's "legal expense bore a reasonable and proximate relation to the conservation of property (shares of stock) held for the production of income."

It is respectfully submitted, that the Court of Appeals erred when it contended that the Tax Court's finding of "reasonableness and proximity" was incorrect, and then concluded that the mere defense against Hannah's suit—even though it admitted that her attack was "unjustified," was "not bona fide," and she sought only to obtain additional income for herself during her life—fixed the purpose for the legal expenditure as a "title" action that required its capitalization as a "part of the cost" of petitioner's shares.

3. The decision below conflicts with decisions in other Circuit Courts of Appeals, concerning the requisites of a "title" action.

A number of Courts of Appeals in other Circuits have held that a legal expense was an addition to the cost of the property, if it was incurred in disputed title-litigation "to cancel a cloud upon title"; "to perfect legal title"; "to quiet title"; "to relieve the property of some lien"; "to acquire title"; "to enhance the value of the property"; or to effect an agreement of settlement with the claimant to the title by paying him a consideration in exchange for the

transfer of property or property rights or for a release of all claims against the title to the taxpayers' property. (*Murphy Oil Co.* v. *Burnet,* 55 F. 2d 17, CA 9, 1932; *Jones' Estate* v. *Commissioner,* 127 F. 2d 231, CA 5, 1942; *Schwabacher* v. *Commissioner,* 132 F. 2d 516, CA 9, 1942; *Louisiana Land & Exploration Co.* v. *Commissioner,* 161 F. 2d 842, CA 5, 1947; *Garrett* v. *Crenshaw,* 196 F. 2d 185, CA 4, 1952; *Brand* v. *Commissioner,* 209 F. 2d 255, CA 6, 1953; *Brown* v. *Commissioner,* 215 F. 2d 697, CA 5, 1954).

It is submitted, that there is no reported case, other than the decision below, which upholds the view that a legal expense for the *bare* defense of an action seeking "income" (and "title" is questioned only as an incident thereto), and *judicially determined* to be wholly without merit, completely unfounded, and not bona fide, and without proof of *some* "addition to or enhancement" of value or the "perfection" of title, constitutes a capital expenditure.

Settlement of this conflict by this Court is in the public interest. When the Court below ignored the "origin and character" of Hannah's claim, and was not concerned with the lack of any evidence in the record which would support a finding that the value of petitioner's shares was "added to or enhanced" by even one cent or that the title was "perfected" in any way, it set forth a view which is clearly contrary to the fundamental concepts in taxation of capital, property rights and property values, and, also, contrary to the many decisions in other Circuits.

4. The decision below cited three cases as authority for its determination; the facts in said cases were clearly distinguishable.

The Court of Appeals cited the cases of *Safety Tube Corp.* v. *Commissioner,* 168 F. 2d 787 (CA 6, 1948); *Schwabacher* v. *Commissioner, supra;* and *American Dis-*

penser Co. v. *Commissioner*, 396 F. 2d 137 (CA 2, 1968), as authority for its holding that the legal expense incurred was a capital expenditure even though the "action which the taxpayer resisted was without merit."

It is respectfully submitted, that the facts in all three cases were clearly distinguishable and had no application to the facts established in the instant case.

a. In all three cases the "origin and character of the claim" was "title." In one case the claimant's suit involved "the very ownership of the (property) itself." In the other two cases the taxpayer *acquired* property or property rights, i.e., a "capital asset," upon payment of a substantial consideration to the claimant, in exchange therefor.

Here, the "origin and character of the claim" was "income." The claimant sought only additional income for herself; she made no claim to "title."

b. In all three cases the taxpayer merely argued that in his opinion the claim made against him was without merit. There was no independent proof submitted to support such finding.

Here, it was *judicially determined* by the Trial Judge in the State Court that Hannah's claim was "utterly incredible" and "wholly without credible support." The Tax Court, based on the record in this case, found that her claim "was not bona fide," "wholly without merit" and "completely unfounded." And, even the Commissioner admitted in his answer to the petition filed in the Tax Court, that her claim was dismissed after trial on the grounds that it was "baseless and totally without merit."

c. In all three cases the Courts made gratuitous statements, that even "assuming" the claim was without merit, or even "assuming" the compromise payment was made

to avoid litigation, such circumstance would not make either the legal expense or compromise payment a deductible expense. Such statements by the Courts were "pure dicta." Their argumentative statements did not establish the authority posed by the Court below. In each case the Court rested its decision on the finding that the legal expense or compromise payment was incurred to acquire "a capital asset" or "to perfect title."

Here, the petitioner acquired absolutely nothing and the title to his shares was not made more "perfect," when he succeeded in dismissing Hannah's suit. Further, he made no payment in compromise or settlement to obtain a release or to acquire any rights or property from her; he resisted vigorously her "groundless" action. When the Tax Court held that her action "was not bona fide" and "wholly without merit," and then decided upon all the facts in the record that the legal expense was incurred in an "income" action, it made a "judicial determination" and not a "gratuitous" statement.

5. The decision below should be reversed, it erroneously interprets Sec. 212(2) of the Code; it applies a meaning to the word "defending" in the Regulation which is arbitrary and unreasonable; it refutes and deems immaterial and without critical significance well-defined facts found by the Tax Court and recognized as material and significant by the decisions of this Court and of other Circuit Courts.

The Tax Court found the following facts, and, it is respectfully submitted, the Court of Appeals erred when it refuted or ignored their materiality and significance:

a. The "primary objective of Hannah's suit was to augment and increase her share of the income of the estate."

The Court of Appeals conceded such fact, but then declared erroneously that such fact was of no "critical significance."

The decisions of this Court and of other Circuit Courts have recognized and established that the "origin and character of (Hannah's) claim" and her purpose and objective were very material and significant in determining whether petitioner's legal expense was "income" and incurred to conserve or maintain his shares held for the production of income, under the Code.

b. Another objective of Hannah's suit was "to obtain an accounting of the profits or earnings" of petitioner's shares.

The Court of Appeals declared erroneously that her suit did not seek such accounting.

In her complaint, she demanded that a Receiver be appointed. Also, the Tax Court found that the executors of the estate, who were served as co-defendants in her action, filed a "protective petition for affirmative relief" that in the event she succeeded, the petitioner should be required "to account for all of the profits collected from (his shares)."

c. "Hannah's claims and lawsuit were wholly without merit and were completely unfounded."

The Court of Appeals held that it was "immaterial that the action which the taxpayer resisted was without merit," and cited the cases of *Safety Tube Corp., supra, Schwabacher, supra,* and *American Dispenser Co., supra,* as authority for such holding.

See, point "4," above, describing the facts in said cases as being clearly distinguishable and without authority to support the holding of the Court below.

d. The "petitioner's purpose in incurring the legal fees in issue * * * was not to perfect (his) title to the shares, but was to maintain and conserve his income-producing property, and was to fend off an attack which was not

bona fide. The legal expense bore a reasonable and proximate relation to the conservation of property (shares of stock) held for the production of income; and * * * comes within the scope and meaning of section 212(2), 1954 Code, and is deductible."

The Court of Appeals held that in view of the fact that the Regulation employed the word "defending" without spelling out any qualifications and without drawing any "distinction between defenses of title against attacks which are not bona fide and defenses against attacks which are," the petitioner's legal expense was "not deductible, regardless of the nature of the attack," and even though the "origin and character" of Hannah's claim was solely to obtain additional income for herself during her lifetime. Further, the Court made such holding even though it conceded that "in a certain sense," when a taxpayer "succeeds in retaining his property against an unjustified attack," he "'conserves' it." Finally, the Court declared, in order to make the Regulation "workable" and to give it "vitality," the word "defending" must be applied in an "unqualified" sense, even though the "origin and character" of Hannah's claim was "income," and not "title," and even though the claim was "unjustified" and *judicially determined* to be "groundless" and "not bona fide."

It is respectfully submitted, that the Court of Appeals interpreted erroneously Sec. 212(2) of the Code, and it applied a meaning to the word "defending" in the Regulation which was arbitrary and unreasonable.

Certainly, it was never the intent of the Congress that if a taxpayer was subjected to a suit involving the income from his property, and such suit was "wholly without merit" and "not bona fide," and, in order to protect his property, he interposed a defense and defeated such "groundless" attack, he was not "conserving or maintaining" such property.

Under the interpretation given by the Court below, even if the Tax Court had *judicially determined* that the petitioner had defeated a "vexatious suit" or a suit steeped in "malicious prosecution," he would still be "defending" the title to his property. Applying such a meaning to the word "defending" in the Regulation, would violate all sound principles of public policy in the fair and reasonable administration of the Federal income tax laws.

In addition, when the Court below declared that the word "defending" must be given primary significance and vitality, even though the "origin and character of the claim" was solely "income," it adopted the extraordinary view that the Regulation must be so interpreted as to negate completely the provisions of the Code, and permit the conversion of an "income" action under the Code, to a "title" action under the Regulation.

In the *Sergievsky* case, *supra,* District Court Judge Herlands described very clearly the hazard of applying such interpretation to the Regulation, and determined that the legal expense was incurred "to conserve income-producing property," and not as an addition to the cost of the property, as contended by the Commissioner. He held at page 238:

> "The mere fact that the plaintiff's Climax shares may have been affected by the Turner (claimant's) action, did not mean that the legal expenditures by plaintiff were directly for the defense of title. Otherwise, every expenditure to conserve income-producing property would be a capital expenditure, thereby emasculating a part of section 23(a)(2) (now Sec. 212, 1954 Code). The statute explicitly permits acts to conserve property without necessarily treating such expense as items of capital cost. Such expenses as were involved in plaintiff's beating off an ill-founded suit did not add to or enhance her property."

Further, when the Court below declared that the acceptance of the Tax Court's decision would make the Regulation "unworkable" and "impractical" to apply, as it believed that "all unsuccessful efforts to wrest from the taxpayer title to his property turn out to be groundless," whether the suit was bona fide or not, it was adopting a view which was contra to several well-established principles of law.

The primary concern of the Court below should have been to give meaning and vitality to the clear and specific language of the Code. The purpose of the Regulation was to interpret the intent of the Congress, and not to alter the meaning of the statute, or to "emasculate" it.

When the Tax Court made a finding that Hannah's suit was "wholly without merit" and "not bona fide," such *judicial determination* fixed a "workable" and not an "uncertain standard" in the construction of the provisions of both the Code and the Regulation.

In addition, when a taxpayer succeeds in dismissing a "title" suit, which the Tax Court found to be "bona fide," then it would be determining that such suit had some merit and substance to its claim of a lien, title or other property rights, and that, perhaps, the claim was denied because of technical interpretations of local statutes, contracts or common law rights involved therein, or because the claimant failed to sustain his burden of proof under the prescribed local standards, or for any other credible reason. Or, the Tax Court may find that the claim had merit and substance because the taxpayer paid a substantial consideration to the claimant for the release of all claims or the transfer of all rights of the claimant. In either case, a *real* claim would have been involved, and a "cloud" would have been removed from the title, the title "quieted," the title "perfected," or property or property rights "acquired"; and the value of taxpayer's prop-

erty was thereby "added to or enhanced." In such a case, the legal expense would be an addition to capital cost.

In contrast, when a taxpayer succeeds in dismissing a "title" suit which the Tax Court found to be "not bona fide," then it would be determining that such suit was "unjustified" and "without merit or substance," and none of the rights and benefits described in the preceding paragraph would have resulted from the dismissal of such *unreal* claim. The legal expense, in such a case, would be a proper deduction under the Code, as it "conserved or maintained income-producing property." And, as in the instant case, if such dismissal and finding were made in an "income" suit, such "conservation or maintenance" would follow because of the "origin and character" of the "income" claim, as well as from the dismissal of a claim which was "not bona fide."

Also, there is the vast and obvious difference between a suit which, in the *opinion* of the taxpayer, was "not bona fide," and which opinion he merely presented as an argument to the Tax Court and without independent proof thereof as against a suit which was *judicially determined* by the Tax Court to be "not bona fide."

Certainly, if the many Courts under our entire body of Federal and State law, constantly determine issues of "first," "second," or other degrees of crimes, various degrees of negligence, "reasonableness," "form versus substance," "except for good cause shown," "by a fair preponderance of the evidence," "beyond a reasonable doubt," and many other standards prescribed by statute or determined by the common law or decisions of the Courts, the Tax Court can be relied upon to draw distinctions "between defenses of title against attacks which are not bona fide and defenses against attacks which are." It is respectfully submitted, that the Court of Appeals erred when it declared that the "applicability of the regulation

cannot depend upon how groundless (attacks against title) are. We perceive no way in which, as a practical matter, such an uncertain standard could be satisfactorily applied."

e. The facts in the instant case were "similar" to those presented in the *Hochschild* case, *supra*, the *Sergievsky* case, *supra*, and the *Zietz* case, *supra*. And, the "reasoning in each of (these) cases applies here."

The Court of Appeals declared that these three cases were "distinguishable" and "sufficiently different to make the decision(s) inapposite here."

It is respectfully submitted, that the Tax Court was correct in this finding. The *Hochschild* case originated in the Tax Court; the *Sergievsky* case involved the same claim as in the *Hochschild* case; and the *Zietz* case was determined by Tax Court Judge Harron who rendered the decision in the instant case. Clearly, Judge Harron was more intimately acquainted with the similarity of the facts involved in the *Zietz* case and in the instant case. And, with reference to the similarity of the facts in the instant case with those presented in the other two cases, a reading of these cases will establish that they were very similar and, if anything, the facts in the instant case were much stronger in favor of the petitioner, as the "origin and character" of Hannah's claim was directed solely to "income," without any claim to "title."

It is respectfully submitted, as the Tax Court found that the petitioner's legal expense "bore a reasonable and proximate relation to the conservation of property (shares of stock) held for the production of income" (see point "2," above); as the Court below did not declare that it was reversing its holding in the *Hochschild* case, when it rendered its decision in the instant case; as the Commissioner had not revoked its acquiescence in the *Zietz* case; and as the decisions of other Circuit Courts have

pointed out that in a "title" action some "addition to or enhancement" of value to the taxpayer's property or the "perfection" of his title, must be established (see point "3," above), settlement of the questions presented in this case is plainly in the public interest. These issues will arise in every case involving the interpretation of Sec. 212(2) of the Code, when confronted with the word "defending" in the Regulation. The Commissioner should desire clarification and settlement of these issues.

6. The decision below conflicts with this Court's decision in *Dobson v. Commissioner*, 320 U. S. 489, that the decision of the Tax Court should stand unless a clear-cut mistake of law is involved.

This Court held in the *Dobson* case that unless the Court of Appeals can "identify a clear-cut mistake of law, the decision of the Tax Court must stand." (320 U.S. at p. 502).

In view of all the facts and findings in the record, as described in the preceding points, it is respectfully submitted, that the Court of Appeals rendered a decision which conflicted with said principle. The decision of the Tax Court was correct on the facts and the law. The decision of the Court of Appeals failed to establish that the Tax Court erred, or that its holding involved a "clear-cut mistake of law."

The several questions presented in the instant case are of great importance and significance in the sound administration of the Federal income tax law. In addition to resolving the serious conflicts described above, it is respectfully submitted, that this Court should grant the review of the decision below and determine whether the Commissioner may apply a meaning to the word "defending" in its Regulation which would convert a claimant's

"income" action under the Code, to a "title" action; which would allow capital to be acquired in a vacuum, without proof that some property or property rights were acquired, title was perfected, or the value of taxpayer's property was added to or enhanced; and which would "emasculate" or even deny the very existence of the clear and specific provisions enacted by the Congress in Sec. 212(2) of the Code.

CONCLUSION

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

MURRAY KURMAN
Attorney for Petitioners
1440 Broadway
New York, New York. 10018

August 19, 1969

APPENDIX

Opinion of the United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 264—September Term, 1968.

(Argued March 13, 1969 Decided June 2, 1969)

Docket No. 32814

SAMUEL GALEWITZ AND MARIAN GALEWITZ,

Appellees,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

Before:

MOORE AND FINEBERG, *Circuit Judges,* and
MCLEAN, *District Judge.**

Appeal by the Commissioner of Internal Revenue from a decision of the Tax Court of the United States determining that there is no deficiency in income tax due from petitioning taxpayers for the taxable year 1961. Reversed.

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* Of the Southern District of New York, sitting by designation.

MITCHELL ROGOVIN, Assistant Attorney General, Washington, D. C. (Lee A. Jackson, William A. Friedlander, Howard M. Koff, Attorneys, Department of Justice, Washington, D. C., on the brief), *for Appellant.*

JOSEPH STRUM, New York, N.Y. (Murray Kurman, New York, N. Y., on the brief), *for Appellees.*

McLEAN, *District Judge*:

Samuel and Marian Galewitz filed a joint income tax return for the calender year 1961 in which they took a deduction for legal fees in the amount of $11,568.95 which Samuel Galewitz paid in that year to attorneys who had represented him in successfully defending an action brought against him and others in the Supreme Court, New York County, by his step-mother, Hannah Galewitz. The Commissioner disallowed the deduction on the ground that the fees constituted "expenses paid . . . in defending . . . title to property" within the meaning of Section 1.212-1(k) of the Treasury Regulations on Income Tax (1954 Code). 26 C.F.R. §1.212-1(k), and hence constituted part of the cost of the property and not a deductible expense.[1]

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[1] The full text of the regulation reads as follows:

§1.212-1.

(k) Expenses paid or incurred in defending or perefecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered must be included in gross income), or in developing or improving property, constitute a part of the

(*Footnote continued on following page*)

Accordingly, the Commissioner notified the taxpayers that determination of their income tax liability disclosed a deficiency in taxes of $7,466.70. The taxpayers thereupon petitioned the Tax Court for redetermination. The Tax Court held that the legal fees were properly deductible under Section 212(2) of the Internal Revenue Code of 1954, 26 U.S.C. §212(2) as ordinary and necessary expenses paid "for the management, conservation, or maintenance of property held for the production of income."[2] Accordingly, the Tax Court decided that there was no deficiency in tax.

Upon the facts disclosed by the record, we conclude that the tax treatment accorded this item by the Commissioner, rather than that adopted by the Tax Court, was correct. We therefore reverse the decision of the Tax Court.

(*Footnote continued from preceding page*)

cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

[2] Section 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> * * *
>
> (2) for the management, conservation, or maintenance of property held for the production of income; . . .

The relevant facts are undisputed. They are embodied in a stipulation entered into by the parties in the Tax Court and in findings of fact set forth in the opinion of the Supreme Court, New York County, which dismissed Hannah Galewitz' action after trial. They may be summarized as follows.

Jacob Galewitz, Samuel's father, married Hannah on November 30, 1931. It was a second marriage for each of them. Jacob had four children by his first wife, including Samuel and his sister Elsie, now Elsie Galewitz Schreiber. Jacob controlled Clinton Paper Corporation (Clinton). At about the time of his marriage to Hannah Jacob organized Walter Peek Paper Corporation (Peek) to act as a sales agent for Clinton. The New York court found that Jacob had done this in order to provide income for Hannah, certain of her friends, and her first husband. Apparently the stock was originally issued to them.

By 1933 Peek was in serious financial difficulty. Its affairs were then liquidated. The New York court found that all of Peek's "outstanding shares were turned in by the stockholders," and that "full control was turned over" to Jacob. Peek ceased to do business and by July 1935 it had no assets. By 1938, however, it had taken a new lease on life as a real estate holding corporation. It has since prospered in that field and now has substantial assets.

On February 25, 1938, Peek issued ten shares of stock, which constituted all the stock which Peek then had or now has outstanding. One share was issued to Jacob, five to Samuel and four to Elsie. The parties stipulated that Samuel and Elsie paid full value for the shares issued to them. Samuel and Elsie were elected directors. Samuel

was made chairman. He became active in the operation of the business. The business grew and dividends were paid on the stock.

Jacob died in 1950. His will was admitted to probate in the Surrogate's Court of New York County. It bequeathed to Hannah $2,500 and the income for life from one-third of his estate. Hannah was dissatisfied with the provision made for her. She embarked upon a course of litigation which continued for some years thereafter in the New York courts.

First she attempted to assert a widow's right of election under Section 18 of the New York Decedent Estate Law to take her intestate share of her husband's estate despite his will. The Surrogate, however, held that the will was sufficient to defeat a right of election. His decision was affirmed by the Appellate Division and in turn by the Court of Appeals. *Matter of Galewitz' Estate*, 3 Misc. 2d 197, 148 N.Y.S. 2d 823 (1955), *affirmed*, 3 A.D. 2d 736, 163 N.Y.S. 2d 937 (1st Dept. 1957), *affirmed*, 5 N.Y. 2d 725, 177 N.Y.S. 2d 710 (1958).

While this proceeding was making its way up through the courts, Hannah began another action, this time in the Supreme Court, New York County. She eventually lost it. This is the action which gave rise to the legal fees with which we are concerned here.

In that action Hannah named as defendants Peck, the executors of Jacob's estate, and Samuel and Elsie individually. She based her claim upon the principle laid down in *Newman* v. *Dore*, 275 N.Y. 371 (1937). She claimed that the nine shares of Peck stock always belonged to Jacob, that the purported issuance of that stock to Samuel and Elsie was a transfer in form only, not in substance, and was "illusory," and that consequently, the

stock formed part of Jacob's estate after his death and had to be taken into account in computing the one-third of his estate from which, under Jacob's will, Hannah was to enjoy the income. Her complaint alleged that Samuel and Elsie had "improperly, falsely and fraudulently claimed" to be the owners of the nine shares, and that the executors had "acquiesced" in their claims. She asked for a judgment setting aside the alleged transfer of the stock to Samuel and Elsie as void.

Samuel and Elsie attempted to secure a dismissal of the action without a trial, but their attempt was unsuccessful. The court held that the complaint stated a cause of action and that the statute of limitations was not a bar. Defendant's motion for summary judgment was denied. *Galewitz* v. *Walter Peek Paper Corporation,* 145 N.Y.S. 2d 402 (N.Y. Co. 1955), *affirmed,* 3 A.D. 2d 741, 161 N.Y.S. 2d 566 (1st Dept. 1957), *leave to appeal denied,* 163 N.Y.S. 2d 363 (1957).

The action then went to trial on the merits. The trial court held that the issuance of the stock to Samuel and Elsie was not "illusory." In the course of its opinion, the court made some uncomplimentary remarks about Hannah, characterizing her testimony as "utterly incredible." and referring to her claim as "wholly without credible support in the record." The judgment for defendants entered upon the trial court's decision was affirmed on appeal. *Galewitz* v. *Walter Peek Paper Corporation,* 15 Misc. 2d 179, 182 N.Y.S. 2d 750 (N.Y. Co. 1958), *affirmed,* 9 A.D. 2d 621, 191 N.Y.S. 2d 359 (1st Dept. 1959).

On these facts, the question before us is whether, in defending this action, Samuel was "defending title to property," *i.e.,* his title to the Peek stock. If he was, then,

under the regulation, his legal expenses paid in the defense are not deductible. It seems to us to be clear that this is precisely what Samuel was doing.

Indeed, the Tax Court recognized in its opinion that "the right of Samuel and Elsie, respectively, to keep the shares was in issue in the litigation," and that "Samuel was obliged to defend his title to 5 shares." Nevertheless, the Tax Court concluded that the legal expenses were deductible as ordinary and necessary expenses paid "for the conservation of property held for the production of income. It is apparent from the court's opinion that in reaching this conclusion, the Tax Court gave controlling weight to the fact that the New York courts had found Hannah's claim to be lacking in merit. The Tax Court held that since Hannah's efforts were "groundless," and since Samuel was merely "fend[ing] off an attack which was not bona fide," he was not defending his title to the stock within the meaning of the regulation.

In our view, this construction of the regulation is not permissible under its terms. The regulation has been in effect for years. This court has recently upheld its validity. *Larchfield Corp.* v. *United States*, 373 F. 2d 159 (2d Cir. 1966). Its language is plain and unqualified. It draws no distinction between defenses of title against attacks which are not bona fide and defenses against attacks which are. If the taxpayer incurred expenses in defending his title, the expenses are not deductible, regardless of the nature of the attack.

Moreover, to read any such distinction into the regulation would render it unworkable. In the final analysis, all unsuccessful efforts to wrest from the taxpayer title to his property turn out to be groundless. The applicability of the regulation cannot depend upon how groundless they

are. We perceive no way in which, as a practical matter, such an uncertain standard could be satisfactorily applied.

There are cases in other circuits which have held it to be immaterial that the action which the taxpayer resisted was without merit. *Safety Tube Corp.* v. *Commissioner,* 168 F. 2d 787 (6th Cir. 1948); *Schwabacher* v. *Commissioner,* 132 F. 2d 516 (9th Cir. 1942). We are in accord with that view. Cf. *American Dispenser Co.* v. *Commissioner of Internal Revenue,* 396 F. 2d 137 (2d Cir. 1968).

There are two other facts in this case which seem to have impressed the Tax Court but which we believe to be without critical significance. In the first place, it can make no difference that Hannah was seeking to recover the Peek stock, not for herself, but for Jacob's estate, in which she had an interest under the will. She was still trying to take the stock away from Samuel and he was still resisting that attempt. In the second place, it is not determinative that the stock produced income. If that fact alone were all-important, then Section 212 would cover every case and the regulation would become a dead letter.

The Tax Court relied upon this court's decision in *Hochschild* v. *Commissioner of Internal Revenue,* 161 F. 2d 817 (2d Cir. 1947), as well as upon *Sergievsky* v. *McNamara,* 135 F. Supp. 233 (S.D.N.Y. 1955). *Hochschild* was criticized, at least inferentially, in *Larchfield,* 373 F. 2d at 166. In any event, we consider it distinguishable from the present case. In *Hochschild* the taxpayer's legal expenses were incurred in the successful defense of a stockholder's derivative action which charged him with having violated his fiduciary obligation as a corporate officer. The stockholder plaintiff claimed that Hochschild had appropriated to himself certain stock which rightfully belonged to the corporation. Plaintiff sought to impress a trust

upon the stock. He also asked for an accounting of all damages caused the corporation and all profits derived by Hochschild from his alleged breach of fiduciary duty. This court (Judge Frank dissenting) held that the legal expenses were deductible as ordinary and necessary expenses of carrying on a business within Section 23(a)(1) of the 1939 Internal Revenue Code (now 26 U.S.C. §162(a)). The court said in substance that Hochschild was engaged in business, that the action charged him with misconduct in the course of that business, and that plaintiff sought to compel him to account for that misconduct.

> "He thereby but fended off an abortive attack upon the conduct of his business as a fiduciary and by freeing himself from liability to his corporation to account for such conduct put all of his property beyond the reach of his then accusers." 161 F. 2d at 819.

Sergievsky presented the same underlying factual situation. It was concerned with the deductibility of litigation expenses incurred by Hochschild's legatees to whom he had bequeathed the same stock which was involved in *Hochschild* v. *Commissioner*. As in *Hochschild*, plaintiff in the action against the legatees sought both an accounting and the imposition of a constructive trust upon the stock. In holding that the expenses were deductible under Section 23(a)(2) of the 1939 Code (now 26 U.S.C. §212(2)), the district court naturally followed this court's decision in *Hochschild*.

The difference between the *Hochschild* facts and the facts we are dealing with here seems to us to be manifest. Hannah did not sue on behalf of Peck. She did not charge Samuel with breach of his fiduciary duty as an officer of Peck. She sought no accounting of damages and profits.

Her action was purely and simply an attempt to void Samuel's title to the stock on the ground that he had never obtained title, in substance, since the transfer to him was "illusory."[3]

Obviously, in every case a taxpayer who succeeds in retaining his property against an unjustified attack "conserves" it in a certain sense. But "conservation" must have a narrower meaning than this. The statute and the regulation exist side by side and it would make no sense to say that every case which falls within the regulation also comes within the statute. We recognize that cases may arise in which it may be difficult to draw the line between them. This does not appear to us to be such a case. If the regulation is to have any vitality, it must govern here.

The decision of the Tax Court is reversed.

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[3] The Tax Court also laid stress on *Willy Zietz*, 34 T.C. 369 (1960). This decision of course is not binding upon us. In any event, its facts which were unusual and complicated, are sufficiently different to make the decision inapposite here. We consider it unnecessary to discuss the case in detail.

Opinion of the Tax Court of the United States

50 T. C. 104

TAX COURT OF THE UNITED STATES

SAMUEL GALEWITZ and MARIAN GALEWITZ, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 1078-66 Filed April 17, 1968.

Petitioner and his sister paid for and held 9 out of 10 shares of stock of a family-owned corporation. The shares were income-producing property. Their father, Jacob, owned one share, which passed to his estate upon his death in 1950. Jacob was survived by Hannah, the step-mother of petitioner, to whom he bequeathed in his will the income, for life, of one-third of his estate. In 1951, Hannah sued petitioner, his sister and others seeking to have set aside the issuance of the 9 shares to petitioner and his sister, and to have those shares made part of Jacob's estate. If that result had been achieved, Hannah's share of the income from Jacob's estate would have been increased. The litigation was lengthy. After trial and decision of the complaint, Hannah's suit was dismissed. The trial and appellate courts in New York found that her complaint was groundless and without merit in fact and law.

Held: That the legal fees paid by petitioner were paid for the purpose of fending off a groundless and ill-founded attempt by his step-mother to have his clearly owned shares transferred to his father's estate. The legal fees were not paid to perfect petitioner's title to the shares. The fees were ordinary and necessary non-business expense of preserving and maintaining income-producing property; they were deductible under section 212(2), 1954 Code.

Murray Kurman, for the petitioners.

Agatha Vorsanger, for the respondent.

OPINION

HARRON, *Judge:* The Commissioner determined a deficiency in income tax for 1961 in the amount of $7,466.70. He disallowed a deduction of legal fees in the amount of $11,568.95.

The question is whether expenditures for legal fees paid in 1961 by Samuel Galewitz, hereinafter called the petitioner, or Samuel, in the amount of $11,568.95, for legal services in the defense of litigation instituted against the petitioner and others constitute ordinary and necessary expenses "for the management, conservation, or maintenance of property held for the production of income", within the provisions of section 212(2), 1954 Code; or are capital expenditures incurred to defend title to and owership of shares of stock of the Walter Peek Paper Corporation and, therefore, are nondeductible expenditures.

The petitioners, residents of New Rochelle, New York, filed their joint return for 1961 with the district director of internal revenue for the Manhattan District of New York City.

All of the facts have been stipulated. The stipulated facts are so found and are incorporated herein by reference. Also incorporated herein by reference are the following: (1) The complaint in the lawsuit filed by Hannah Galewitz against Samuel Galewitz, Walter Peek Paper Corporation, and others in the Supreme Court of the State of New York, County of New York. (2) The answer to the complaint filed in the same court by the defendants. (3) The opinion of the New York County Supreme Court denying on September 29, 1955, the defendants' motion to dismiss the complaint and for summary judgment, *Galewitz* v. *Walter Peek Paper Corpora-*

tion, et al, 145 N.Y.S. 2d 402 (1955), affirmed 161 N.Y.S. 2d 566 (1957). (4) The opinion of the New York County Supreme Court in *Galewitz* v. *Walter Peek Paper Corporation, et al,* 182 N.Y.S. 2d 750 (1958), affirmed 191 N.Y.S. 2d 359 (1959), by which the lawsuit was decided against Hannah, and her suit was dismissed.

The facts are as follows: Jacob Galewitz, the father of Samuel Galewitz, died testate on October 10, 1950. Samuel is one of the executors named in Jacob's will dated March 22, 1950. Jacob was survived by Hannah Galewitz, his second wife, and 6 children; 2 are children of Jacob and Hannah, and 4 are children of Jacob and his first wife. Samuel and Elsie Galewitz Schreiber are children of Jacob and his first wife. Hannah and Jacob were married on November 30, 1931.

In his will, Jacob provided that Hannah was to receive $2,500, cash, and in addition, the income for her life of one-third of his estate. The principal of Jacob's estate was to be divided equally among his 6 children. All of the children were adults. The gross estate was about $1,200,000, and the net estate was estimated as about $716,000. There is no problem here about the payment of the cash bequest to the widow.

After the executors were appointed by the Surrogate's Court on February 26, 1951, Hannah filed a lawsuit in August 1954 against the Manhattan Company and Samuel, the executors of the estate, and against Samuel and Elsie G. Schreiber, individually, and Walter Peek Paper Corporation, by which she tried to have set aside, "as illusory and fraudulent, the transfer or issuance of 9 out of 10 shares" of the outstanding stock of Walter Peek Paper Corporation (hereinafter called Peek corporation), which shares had been issued by the corporation in 1938, 5 shares to Samuel and 4 shares to Elsie. The remaining

1 share had been issued to Jacob and was part of the assets of his estate.

Samuel paid the legal fees in issue in 1961 to his attorneys, Vaughan & Lyons, for their legal services to him in his defense in that lawsuit, in his individual capacity.

The facts about Peek corporation which have been stipulated, admitted in the pleadings, and found by the Supreme Court for New York County in *Galewitz* v. *Walter Peek Paper Corporation,* 182 N.Y.S. 2d 750, *supra,* are as follows: At some time before he married Hannah on November 30, 1931, Jacob organized the Peek corporation under the laws of New York for the purpose of conducting a business of selling paper made for another corporation controlled by Jacob, the Clinton Paper Company. It was Jacob's intention that the earnings of Peek corporation would provide income for Hannah, a few of her friends, and her then husband whom she was to divorce. Peek corporation was in serious financial difficulties in 1933 and was indebted to Clinton Paper Corporation. Full control of Peek was given to Jacob under an agreement dated February 14, 1933. Peek ceased all operations in the paper business in 1935. On July 1, 1935, it had no assets, and liabilities of over $1,700. When it was in difficulties in 1933, all its affairs were liquidated and all original outstanding shares were turned in as worthless by the stockholders. As of July 1, 1936 and for 1937, Peek's income tax returns showed no income and no assets. The tax return for 1938 showed that the business of Peek corporation had been changed to a realty holding corporation, and that Jacob was its president. Minutes of the corporation dated February 25, 1938, show the election of Jacob, Samuel and Elsie as directors and officers; Samuel was the chairman and Jacob was the treasurer. The 1938 tax return of Peek corporation also shows that 10 shares

were outstanding and were held 1 by Jacob, 5 by Samuel, and 4 by Elsie. Samuel was an officer and director of Peek at all times after 1938 and was active in the management of the corporation, which eventually became the owner of substantial real estate properties.

Only 10 shares of stock of Peek were outstanding in 1938 and thereafter. It is stipulated that Jacob, Samuel, and Elsie, individually, fully paid the corporation for his and her shares; and that the corporation issued the shares to each of them. Those shares were issued on February 25, 1938.

In its findings, the New York County Supreme Court in the suit of Hannah Galewitz, *supra,* found that there was nothing of an "illusory" nature in the operations of the Peek corporation in 1938 and thereafter.

From the time Samuel acquired his 5 shares in 1938 until Jacob died in 1950, Samuel received $11,250 dividends on his 5 shares, and he included them in his tax returns.

In her lawsuit, Hannah did not claim that the 9 shares held by Samuel and Elsie belonged to her. Rather, she sought to recapture the 9 shares for Jacob's estate. The 9 shares had not been issued first to Jacob and then transferred by him to Samuel and Elsie; the corporation had issued them directly to Samuel and Elsie. That issuance of the 9 shares by the Peek corporation was what Elsie sought to have set aside in her lawsuit. Also, she petitioned for the appointment of a receiver. But a receiver was never appointed.

Samuel and the other defendants, including the Peek corporation, did not institute a lawsuit against Hannah. But they filed a motion to dismiss her suit on the ground that it did not state a good cause of action, and for sum-

mary judgment. Their motion was denied, and the case was tried. On appeal, that ruling was affirmed in 1957. But after trial, the court dismissed the complaint under a written opinion.

In her complaint, Hannah alleged *inter alia* that the issuance of the 9 shares to Samuel and Elsie "constituted a fraudulent and illusory transfer of the assets of the said Jacob P. Galewitz, deceased."

As a preliminary step, Hannah sought to exercise an election to inherit from Jacob, as in a case of intestacy, under section 18 of the New York Decedent Estate Law; but the Surrogate denied her such right of election, and his ruling was sustained on appeal. *Matter of Galewitz' Estate,* 148 N.Y.S. 2d 823, affirmed 163 N.Y.S. 2d 937, and 177 N.Y.S. 2d 710.

In view of their being named defendants in Hannah's suit, the executors of Jacob's estate filed a protective petition for affirmative relief, in which they asked that in the event the court should hold that the estate was the owner of the 9 shares, then Samuel and Elsie should be required to deliver them to the executors and to account for all of the profits collected from them.

Hannah's suit went to trial. On November 26, 1958, the New York County Supreme Court, under a written opinion and findings, dismissed the complaint. In its opinion, the court stated, *inter alia,* the following: That the action by Hannah was to set aside, as illusory and fraudulent (i.e., not real), the transfer or issuance of 9 out of 10 outstanding shares of the Peek corporation to Samuel and Elsie, children of her deceased husband; that the 9 shares had been issued directly by the corporation on February 25, 1938; that it was the issuance of this stock which the plaintiff sought to set aside; and that

the executors properly were named as defendants since a recovery by the plaintiff would be equivalent to finding that the decedent, Jacob, was the owner at death of the 9 shares issued in 1938 to Samuel and Elsie.

The court stated and concluded that on issues pertinent to the business or transactions of the Peek corporation, Hannah's testimony was hardly credible; and that her testimony about payment for the stock originally issued, "and her reimbursement to the original shareholders" was "without support other than her own word, is [was] utterly incredible and was in fact undermined by her own testimony." The court set forth the facts about the financial difficulties of the corporation in 1933; about the liquidation of its affairs, and the turning in of the original shares, as worthless, by the shareholders; and about the issuance of the new shares by the corporation on February 25, 1938. (All of those facts have been set forth hereinabove.) The court reviewed the facts about what was shown in the tax returns of the corporation for the taxable periods 1935, 1936, 1937, and 1938; and about the records and minutes of the corporation, and concluded that "Nothing of an 'illusory' character is anywhere observed in this operation." (p. 753). The court found that "There had been no change in any of the wills [of Jacob] in the matter of the Peek corporation shares and the holding by the deceased of but one of the ten outstanding shares. * * * There was nothing of an 'illustory nature' in the ownership by defendants Samuel and Elsie of the 9 shares of the Peek corporation issued to them in 1938. Any claim of plaintiff herself, or on behalf of the estate by her, to said shares is wholly without credible support in the record." The court concluded its opinion as follows:

> On the other hand, deceased had on a number of occasions acted in relation to the Peek corporation affairs and the respective interests of his son and daughter therein from February, 1938 on. Deceased signed the minutes of the Peek corporation of February 25, 1938; he signed the stock certificates here challenged; he signed the franchise tax returns recording the ownership of the shares; he made declarations on the returns of the Clinton Paper Corporation and to his counsel—all bearing on the reality and good faith of the Peek corporate stock ownership. All this, combined with the active operation of the business by his son, Samuel, both of Peek and Clinton—*these furnish indisputable proof of the unassailability of the transaction under attack.* Let judgment be entered dismissing the complaint but without costs. (Italics added.)

The foregoing facts are the substantial facts about the lawsuit of Hannah. Her complaint was dismissed. The court did *not* find any merit in her claim that the corporation's issuance of the 9 shares in 1938 to Samuel and Elsie was not real and was "illusory and fraudulent"; and the court held that the issuance of 5 shares to Samuel and 4 shares to Elsie could *not* be set aside as illusory and fraudulent as to Hannah or to Jacob's estate.

Other facts are: Since the end of the litigation, Peek corporation has paid, regularly, substantial dividends. In 1961, Samuel received on his 5 shares dividends in the amount of $10,500.

We turn now to discussion of the issue and our decision thereof. As stated at the outset, the question arises under section 212(2), and is whether Samuel's legal expense of $11,568.95, in his own defense in the litigation insti-

tuted by Hannah, is deductible as nonbusiness expense in conserving and maintaining property held for the production of income.

Petitioner contends that Hannah did not seek to obtain a determination that the 9 shares should be transferred to herself, but, rather, she attempted to have the transfer of the shares to Samuel and Elsie set aside, and to have a determination made that Jacob owned the shares at the time of his death, and therefore they should be transferred to the executors of his estate as property of the estate. That contention of the petitioner is correct.

Petitioner contends, further, that the primary objective of Hannah's suit was to augment and increase her share of the income of the estate, and to obtain an accounting of the profits or earnings of the 9 shares. We believe that this contention is basically correct.

The facts found by the New York County Supreme Court are to the effect that in 1938 Peek corporation became a real estate holding corporation. The evidence in this case is to the effect that in the period 1938 until Jacob's death in October 1950, Peek's real estate business was quite profitable and it paid substantial dividends. That is to say, the shares of stock of Peek corporation were income-producing property. Hannah's interest in Jacob's estate was limited to a life interest in the income of one-third of his estate, and if it had been determined, as the result of Hannah's suit, that the 9 shares had belonged in reality to Jacob, and hence to his estate upon his death, the amount of the income of the estate would have been increased substantially, and so would her share of that income.

Petitioner contends, also, that Hannah's suit, to have a determination made that the issuance by Peek of the

9 shares to Samuel and Elsie was "illusory and fraudulent," and therefore should be set aside, was without merit and was ill-founded. We agree with that contention for the following reasons: The respondent has agreed and stipulated in this case that each of the individuals to whom Peek corporation issued the new stock in 1938, i.e., Jacob, Samuel, and Elsie, made full payment to the corporation, individually, for those shares. Furthermore, the New York County Supreme Court, upon trial of Hannah's claims, found and held that there was nothing "illusory" in the whole operation involving the issuance by the corporation of the new stock in 1938, and the conduct of its business thereafter by Jacob and Samuel, as officers and directors; that the corporate transactions had been satisfactorily accounted for; and that Hannah's claims were no more than "a weak attempt" to explain away those satisfactorily explained transactions, and that all of the evidence furnished "undisputable proof of the unassailability of the transaction under attack," namely the issuance of the 9 shares to Samuel and Elsie. The court characterized Hannah's testimony as "hardly credible" (about some of her allegations), and as "utterly incredible" (in other instances).

Upon all of the evidence here, we must find and conclude, and we do, that Hannah's claims and lawsuit were wholly without merit and were completely unfounded.

It is true that in suing to set aside the corporation's issuance on February 25, 1938, of 5 shares to Samuel and 4 shares to Elsie, Hannah attacked the validity of the title to and ownership of those shares by Samuel and Elsie, respectively; and she put each of them to the effort and expense of defending his and her ownership of the shares. The right of Samuel and Elsie, respectively, to

keep the shares was in issue in the litigation. Referring now simply to the petitioner, in this case, Samuel was obliged to defend his title to 5 shares.

The narrow question in this case is whether having had to defend his title to the 5 shares, under all of the circumstances, and in defense against claims that were lacking in merit or substance, the legal expense must be capitalized as a capital cost, or can be deducted as a non-business expense.

For the petitioner it must be said that he had owned and held the 5 shares for 16½ years prior to Hannah's suit, and during that period of time, he had received $11,250 in dividends. The shares constituted income-producing property.

It was said in *Sergievsky* v. *McNamara*, 135 F. Supp. 233, 236 (D.C. S.D. New York, 1955):

> Viewed realistically, plaintiff's defense of the Turner action and her personal payment of her share of the legal expenses incident to the defense of that lawsuit, represented action to preserve income-producing property that she owned personally.
>
> * * *
>
> In general, the cost of the legal defense of title to property is a capital expenditure. In the category of capital expenses are legal fees paid to quiet or perfect title to land, to defend an action to invalidate a sale of stock, and to defend a statutory proceeding for the perpetuation of testimony with regard to a claim for property.
>
> However, the "line of demarcation between an 'ordinary' and necessary expense' as a deductible item and an expenditure incurred in defense of title

> to property and therefore not deductible is extremely narrow. In fact, in some of the cases it appears to have been drawn on an arbitrary rather than on a basis of reason or logic." [Quotation from *Rassenfoss* v. *Commissioner,* 158 F. 2d 764, 766.]

See, also, *Hochschild* v. *Commissioner,* 161 F. 2d 817 (C.A. 2, 1947); and *Willy Zietz,* 34 T.C. 369 (1960).

In each of the three cases cited above, the taxpayer paid legal fees for the successful defense of an action challenging his rightful ownership of dividend-paying securities, such challenging action having been judicially determined to be "ill-founded," or "wholly without merit," or an "abortive attack."

The taxpayer in each of the *Sergievsky* and *Horchschild* cases, respectively, was a successful defendant in another stockholder's derivative lawsuit, whereby the taxpayer-defendant's ownership of certain shares of stock of a corporation was challenged, and the person bringing the lawsuit sought to have the court order that the shares in question should be transferred back to the corporation by the taxpayer-defendant, or that the taxpayer-defendant should be required to account for the value of the shares, if the shares previously had been sold. In the *Hochschild* case, the taxpayer was allowed deduction of his legal expense in his defense, as an ordinary and necessary business expense. In the *Sergievsky* case, the taxpayer was allowed a deduction of his legal expense in his defense, as an ordinary and necessary nonbusiness expense. The court, in the *Hochschild* case stressed the point that the necessary legal expense "fended off an abortive attack." In the *Sergievsky* case, the trial court stressed the point that defensive legal expense was incurred in "beating off an ill-founded suit."

In the *Zietz* case, the facts were similar to those presented in the instant case. Willy Zietz incurred and paid legal fees totaling $9,977, for services of several lawyers, in 2 types of litigation, as is explained in the findings and opinion in *Willy Zietz, supra,* pp. 369-372. The first type of litigation involved the taxpayer's efforts to have the value of his own assets excluded from the alleged value of his deceased mother's separate estate; taxing authorities claimed that properties owned by Willy Zietz were part of his mother's estate. We held (p. 385) that the legal fees of $3,647, incurred in those matters, were incurred and paid in order to conserve and maintain Willy's own income-producing property and, therefore, were deductible. The second group of legal fees, $6,330, incurred in another kind of defensive litigation, were held to be deductible because they, too, were incurred in conserving and maintaining income-producing property owned by the taxpayer, under the following circumstances: The taxpayer, Willy Zietz, was successful after lengthy litigation in local Swiss courts in obtaining the dismissal of the claims of the divorced wife, Madeline, of his deceased brother, Hugo, Jr., who was endeavoring to take away from Willy assets derived from his father's estate. She claimed that her divorce from Hugo, Jr., was illegal, and that she was entitled, as his so-called "widow," to the one-half share of the assets of their father's estate which had passed to Willy Zietz, as the sole "reversionary" survivor under German law (after the death of their mother and the brother) under the will of their father. The mother, of Willy and the deceased brother, was the "provisional" heir under German law of her deceased husband's estate for life. The 2 sons, or the survivor, were the final, or "reversionary heirs" (under German law), after the death of their mother. This Court stated in *Willy Zietz, supra,* at pp. 382, 383:

> The situation here is one which requires practical application of the tax statute in an unusual setting. In the first place, it was judicially determined by several Swiss courts that the claims of Madeleine were wholly without merit and malicious. Madeleine had no valid basis for seeking to obtain any of the assets which had passed to the petitioner under his father's will upon the death of his mother. That was her purpose. * * *
>
> It would be inaccurate and unrealistic to say that Madeleine's suits were bona fide attacks on petitioner's title to the property which he had inherited from his father. * * *
>
> * * *
>
> Our conclusion here is that petitioner's purpose in incurring the legal fees paid to resist Vogt's efforts to attach and tie up some of his securities, which he owned as part of the remainder of the assets of his father's estate, was not to perfect his title to the securities but was to maintain and conserve his income-producing property. The legal expense bore a reasonable and proximate relation to the conservation of property held for the production of income. Cf. *Bingham's Trust* v. *Commissioner, supra.* It is held that the legal fees amounting to $6,330 fall within the scope and meaning of section 23(a)(2) and are deductible as ordinary and necessary nonbusiness expense.

The reasoning in each of the cases, *Willy Zietz, supra, Sergievsky,* and *Hochschild,* applies here. See also, *Bingham's Trust* v. *Commissioner,* 325 U. S. 365; *Frederick E. Rowe,* 24 T.C. 382; and *Allen* v. *Selig,* 200 F. 2d 487, affirming 104 F. Supp. 390.

It is held that petitioner's purpose in incurring the legal fees in issue to resist Hannah's groundless efforts to obtain a transfer of his 5 shares of Peek stock to the executors of the estate of his father, Jacob *Galewitz,* deceased, was not to perfect Samuel's title to the shares, but was to maintain and conserve his income-producing property and was to fend off an attack which was not bona fide. The legal expense bore a reasonable and proximate relation to the conservation of property (shares of stock) held for the production of income; and the legal fee of $11,568.95 comes within the scope and meaning of section 212(2), 1954 Code, and is deductible.

Careful consideration has been given to the respondent's argument and the cases on which he relies. He relies largely on *Estate of Joseph P. Morgan* v. *Commissioner,* 332 F. 2d 144, affirming and reversing in part 37 T.C. 31, on the apportionment of expenses between defense of title and protection of income from the property. The conclusion here is in harmony with the guidelines set forth in the *Morgan* case. This case is distinguishable on its facts from *Morgan Jones Estate,* 43 B.T.A. 691, affirmed 127 F. 2d 231; *Addison* v. *Commissioner,* 177 F. 2d 521, 523; and *E. W. Brown, Jr.,* 19 T.C. 87, affirmed 215 F. 2d 697.

Decision will be entered for the petitioners.

Statutes and Regulations Involved

Internal Revenue Code of 1954:

Sec. 212. **Expenses for Production of Income.**

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

* * *

(2) for the management, conservation, or maintenance of property held for the production of income;

* * *

(26 U.S.C. Sec. 212)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.212-1. **Nontrade or nonbusiness expenses.—**

(a) An expense may be deducted under section 212 only if—

(1) It has been paid or incurred by the taxpayer during the taxable year * * * (ii) for the management, conservation, or maintenance of property held for the production of such income, * * *

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

* * *

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands

are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

* * *

(26 C.F.R. Sec. 1.212-1)

In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 485

SAMUEL GALEWITZ AND MARIAN GALEWITZ,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 11-25) is reported at 50 T.C. 104. The opinion of the court of appeals (Pet. App. 1-10) is not yet officially reported.

JURISDICTION

The judgment of the court of appeals was entered on June 2, 1969. The petition for a writ of certio-

rari was filed on August 20, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, for federal income tax purposes, legal expenditures incurred in defending a groundless attack on title to stock are nondeductible capital expenditures, rather than currently deductible ordinary and necessary expenses for the management, conservation or maintenance of property held for the production of income.

STATUTE AND REGULATIONS INVOLVED

Section 212 of the Internal Revenue Code of 1954 and Section 1.212-1(k) of Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 10-11.

STATEMENT

Petitioner [1] seeks a deduction for legal fees of $11,568.95 paid in 1961 to attorneys who had represented him in successfully defending an action brought against him and others in the Supreme Court, New York County, by his stepmother, Hannah Galewitz. The Commissioner disallowed the deduction on the ground that the fees constituted "expenses paid * * * in defending * * * title to property" within the

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[1] References to petitioner herein are to Samuel Galewitz only. Marian Galewitz, his wife, is a party to this action solely by virtue of the filing of a joint income tax return for the year in issue.

meaning of Section 1.212-1(k) of the Treasury Regulations on Income Tax (1954 Code), and hence constituted a capital charge to be added to the basis of the property and not a deductible expense. (Pet. App. 2a.)

The Tax Court held that the legal fees were deductible under Section 212(2) of the Internal Revenue Code of 1954, as ordinary and necessary expenses paid "for the management, conservation, or maintenance of property held for the production of income" (Pet. App. 11a-25a). On appeal, the Court of Appeals for the Second Circuit adopted the Commissioner's position and reversed the decision of the Tax Court (Pet. App. 1a-10a).

The relevant facts are undisputed (Pet. App. 4a, 12a), and may be summarized as follows:

Petitioner's father, Jacob Galewitz, died testate on October 10, 1950, survived by Hannah Galewitz, his second wife, and six children. Petitioner and Elsie Galewitz Schreiber are children of Jacob and his first wife. (Pet. App. 4a, 13a.) In his will, Jacob provided that Hannah was to receive $2,500 outright and the income for her life of one-third of his estate. Because Hannah was dissatisfied with the provision made for her, she embarked upon a course of litigation which continued for some years thereafter in the New York courts (Pet. App. 5a).

First she attempted unsuccessfully to assert a widow's right of election under Section 18 of the New York Decedent Estate Law to take her intestate share of her husband's estate despite his will. *Matter of Galewitz' Estate*, 3 Misc. 2d 197, 148 N.Y.S.

2d 823 (1955), affirmed, 3 App. Div. 2d 736, 163 N.Y.S. 2d 937 (1st Dept. 1957), affirmed, 5 N.Y. 2d 725, 177 N.Y.S. 2d 710 (1958). (Pet. App. 5a.)

While that litigation was progressing through the courts, Hannah began another action, also unsuccessful, in the Supreme Court, New York County. In that action—which gave rise to the legal fees in issue here (Pet. App. 5a, 13a-14a)—Hannah named as defendants the Walter Peek Paper Corporation, executors of Jacob's estate, and petitioner and Elsie individually. She claimed that nine shares of Peek stock for which petitioner and Elsie had paid full value had always belonged to Jacob, that issuance of the stock to petitioner and Elsie was a transfer in form only, not in substance, and was "illusory," and that, consequently, the stock should be declared part of Jacob's estate. She asked for a judgment setting aside the alleged transfer of the stock to petitioner and Elsie as void. (Pet. App. 4a, 5a-6a, 13a.)

The trial court held that the issuance of the stock to petitioner and Elsie was not "illusory" and sustained their title to the stock. In the course of its opinion, the court characterized Hannah's testimony as "utterly incredible," referring to her claim as "wholly without credible support in the record." On appeal, the trial court's judgment was affirmed. *Galewitz* v. *Walter Peek Paper Corp.*, 15 Misc. 2d 179, 182 N.Y.S. 2d 750 (N.Y. Co. 1958), affirmed, 9 App. Div. 2d 621, 191 N.Y.S. 2d 359 (1st Dept. 1959). (Pet. App. 6a, 16a-18a.)

The court of appeals concluded on these facts that the claimed deduction for legal fees should be disal-

lowed because the fees were paid in defending petitioner's title to property and thus constituted capital expenditures rather than currently deductible expenses. (Pet. App. 6a-10a.)

ARGUMENT

The decision below, holding that the payments in question were made to defend title to property, is legally and factually correct. There is no conflict or other ground for further review by this Court.

1. Pursuant to Section 1.212-1(k), Treasury Regulations on Income Tax (1954 Code), Appendix, *infra*, p. 10, expenses paid or incurred in "defending * * * title to property" are deemed to be capital expenditures, rather than currently deductible expenses. In defending the action brought by Hannah, petitioner "was 'defending title to property,' *i.e.*, his title to the Peek stock" (Pet. App. 6a) as the court of appeals held (Pet. App. 7a).

2. There is no merit to petitioner's claim (Pet. 14-18) that because Hannah's suit was groundless, he was not defending his title to the stock but was merely maintaining and conserving income producing property and is therefore entitled to a deduction under Section 212(2). Section 1.212-1(k) makes no distinctions between title defenses to challenges that are bona fide and others that are baseless. It prescribes a reasonable rule designed to avoid the administrative difficulties that would result if deductibility of title defense costs turned on the degree of merit to the plaintiff's suit. The regulation was